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Kodak v. Image Technical Services: A Setback for the Chicago School of Antitrust Analysis

Jill Dickey Protos

KODAK V IMAGE TECHNICAL SERVICES: A SETBACK FOR THE CHICAGO SCHOOL OF ANTITRUST ANALYSIS

I. INTRODUCTION

Justice Holmes once referred to the Sherman Act as "humbug based on economic ignorance and incompetence."[1] Indeed, this description was well deserved back in the days known as the pre-economic age of antitrust, when courts "relied more on antiquated concepts of title applied in property or sales law than on the economic consequences of challenged transactions."[2] During the last two decades, however, criticism based on the failure to integrate economic theory into antitrust policy has become less legitimate. Since the late 1970's, the Supreme Court has shifted the focus of antitrust jurisprudence towards the goal of economic efficiency, largely echoing the scholarship of the Chicago School theorists.[3]

During its 1992 Term, however, the United States Supreme Court in *Eastman Kodak Co. v. Image Technical Services, Inc.*[4]

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1. ERNEST GELLHORN, ANTITRUST LAW AND ECONOMICS IN A NUTSHELL XVII (West 1986) (quoting 1 HOLMES-POLLOCK LETTERS 163 (Howe ed. 1941).

2. *Id.*

3. Jean Wegman Burns, *The New Role of Coercion in Antitrust*, 60 FORDHAM L. REV. 379, 379 (1991). The phrase "Chicago School of Antitrust Analysis" is used as a term of art to refer to a "body of antitrust views" formulated by Professor Aaron Director in the 1950's, and expanded upon by disciples such as Richard Posner and Robert Bork. Richard A. Posner, *The Chicago School of Antitrust Analysis*, 127 U. PA. L. REV. 925, 925-26 (1979). The cornerstone of the Chicago School is economic theory. *Id.* at 933-34. Economic theory is thought to play an essential role in antitrust because "the central focus of antitrust is the control of monopoly, and the study of monopoly has been a major activity of economists for many years." Richard A. Posner, *The Economic Approach to Law*, 53 TEX. L. REV. 757, 758 (1975). Thus, Chicago School adherents seek to use economic models to explain business practices, and their rationales and consequences, to develop an efficient body of antitrust law. *Id.* at 757-65.

4. 112 S. Ct. 2072 (1992).

may have signaled "a return to the pre-economic dark ages of antitrust,"[5] or at least a reluctance to base antitrust principles solely on economic theory In *Kodak*, eighteen independent photocopier service organizations ("ISOs"), which had been engaged in the business of servicing Kodak copying equipment since the early 1980's, alleged that Kodak's new policy of selling its photocopier replacement parts to only those who also used its repair service constituted an antitrust violation.[6] Specifically, the ISO's claimed that Kodak had tied the sale of service for Kodak equipment to the sale of Kodak replacement parts in violation of § 1 of the Sherman Act.[7]

Under controlling case law, Kodak would be required to have "sufficient market power" in the photocopier replacement parts market in order to be held liable for violation of the Sherman Act.[8] Thus, the central issue in the case was whether Kodak possessed this required market power. Kodak's contention that it lacked the required market power in the photocopier replacement parts market was based on "Chicago School" economic theory[9] This economic theory posits that competition in the interbrand equipment market[10] necessarily prevents Kodak from exercising its market power in the equipment aftermarkets[11] required for a Sherman Act violation. Furthermore, competition in the interbrand market is alleged to preclude the exercise of market power in the aftermarkets since the two markets are interrelated. Simply put, interrelation exists because photocopier parts and service are essential for fully functioning photocopier equipment.

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5. David Frum, *Whom Should the Law Protect?*, FORBES, Nov. 9, 1992.

6. *Kodak*, 112 S. Ct. at 2077.

7. *Id. See infra* text accompanying notes 29-50 (for an explanation of tying and the Sherman Act).

The ISO's also alleged that Kodak's policy of restricting the sale of Kodak parts was an attempt to monopolize the sale of service for Kodak equipment in violation of § 2 of the Sherman Act. *Id.* at 2078. The bulk of the Court's analysis, and thus the important implications for the future of antitrust law, center on the tying claim and § 1 of the Sherman Act. Accordingly, this Comment focuses solely on the tying aspect of the dispute.

8. *See infra* text accompanying notes 43-50.

9. *Kodak*, 112 S. Ct. at 2081-82. *See infra* text accompanying notes 36-37.

10. "Interbrand" denotes the existence of competition between retailers of the same product. *Id.* at 2084-85, n.18. This case involves retail competition between different brands of photocopier equipment such as Xerox, Cannon, Minolta, etc.

11. "Aftermarkets" refers to products that derive from the primary product market. For example, the markets for photocopier parts and service stem from the existence of the market for photocopier equipment.

Consequently, Kodak alleged that if it raised the price of its parts and service above competitive levels, consumers would simply purchase an alternative photocopier equipment brand with more attractive parts and service costs. Kodak further argued that it lacked the market power to engage in monopoly practices in the parts and services markets because such an action would jeopardize sales volume in the primary photocopier equipment market. In other words, any gains realized by anti-competitive practices in the parts and service market would be offset by losses in the photocopier equipment market. Based on this economic reasoning, Kodak urged the adoption of a substantive legal rule that competition in primary markets precludes the finding of market power in derivative aftermarkets.[12]

Although the Supreme Court had previously embraced economic theory as an essential element of antitrust analysis,[13] Justice Blackmun, writing for the majority, refused to accept Kodak's "'basic economic reality'" as a substantive rule of law.[14] Thus, *Kodak* represents an important decision in the evaluation of whether antitrust law is, as Justice Holmes claimed, "humbug based on economic ignorance and incompetence."[15]

In an effort to evaluate whether antitrust law, specifically the law concerning tying arrangements, is moving in an "economically intelligent direction," this Comment will analyze the *Kodak* case with reference to the economic theory which has influenced the Court over the past decades. This Comment will first examine the Court's interpretation of § 1 of the Sherman Act in an effort to not only explain the black letter law of a successful tying claim, but also to provide an understanding of how the law relates to economic theory.[16] This Comment will then discuss the merits of the Court's conclusion that economic theory alone cannot be used to rule on claims of unlawful tying arrangements.[17] This Comment

12. *Kodak*, 112 S. Ct. at 2082.

13. *See, e.g.*, Monsanto Co. v. Spray-Rite Service Corp., 465 U.S. 752, 762-64 (1984) (reliance on economic theory to narrow the prohibition against price fixing by imposing a greater burden of proof on plaintiffs); Continental T.V., Inc. v. GTE Sylvania, Inc., 433 U.S. 36, 58-59 (1977) (application of a rule of reason standard, instead of a *per se* standard, as evidence of the Chicago School efficiency theory impact on the legal treatment of vertical restraints).

14. *Kodak*, 112 S. Ct. at 2084.

15. *See supra* note 1 and accompanying text.

16. *See infra* text accompanying notes 19-61.

17. *See infra* text accompanying notes 62-98.

concludes that *Kodak* represents not only a setback to the "Chicago School" of antitrust analysis, but may have an adverse effect on the competition which antitrust laws are designed to protect.[18]

II. ANTITRUST PRINCIPLES AND ECONOMIC THEORY: THE COURT'S INTERPRETATION OF THE SHERMAN ACT

Antitrust law is based on the assumption that society is better off when markets are competitive.[19] In a competitive market, buyers attempt to maximize their satisfaction by allocating resources among different products, while producers allocate their resources by producing those products that the consumers value the most at the lowest possible cost per unit.[20] In the aggregate, societal wealth is therefore maximized because consumer utility is achieved by the sacrifice of the fewest resources. This goal of competitive market maintenance, coupled with concern over abusive business practices by industrial giants in the late 19th century, led to the passage of the Sherman Antitrust Act.[21]

The substantive provisions of the Act are vague and set forth only general principles. For example, the key statutory prohibitions on non-competitive practices are "restraints of trade" in § 1 and "monopolization" in § 2.[22] Thus, because the Sherman Act was written in such generic terms, it has been necessary for the courts to develop an analysis to draw the line between legal/competitive and illegal/non-competitive business practices.[23] The Supreme Court has articulated two modes of analysis to evaluate whether a particular business practice crosses the prohibited line: the *per se* rule and the rule of reason. Justice Stevens explained the two different standards as:

> two complementary categories of antitrust analysis. In the first category are agreements whose nature and necessary effect are so plainly anticompetitive that no elaborate study

18. *See infra* text accompanying notes 99-116.

19. *See, e.g.*, United States v. Trenton Potteries Co., 273 U.S. 392, 397 (1927) (stating that "the Sherman Law and the judicial decisions interpreting it are based on upon the assumption that the public interest is best protected from the evils of monopoly and price control by the maintenance of competition."). *See also* E. THOMAS SULLIVAN & JEFFREY L. HARRISON, UNDERSTANDING ANTITRUST AND ITS ECONOMIC IMPLICATIONS, 1 (1988).

20. SULLIVAN & HARRISON, *supra* note 19, at 9.

21. Gellhorn, *supra* note 1, at 19-20.

22. 15 U.S.C. § 1 and § 2.

23. Sullivan and Harrison, *supra* note 19, at 6.

> of the industry is needed to establish their illegality — they are "illegal *per se*." In the second [rule of reason] category are agreements whose competitive effect can only be evaluated by analyzing the facts peculiar to the business, the history of the restraint, and the reasons why it was imposed. In either event, the purpose of the analysis is to form a judgment about the competitive significance of the restraint; it is not to decide whether a policy favoring competition is in the public interest, or in the interest of the members of an industry Subject to exceptions defined by statute, that policy decision has been made by the Congress.[24]

In other words, the Court characterizes particular conduct as *per se* illegal when the extreme anticompetitive nature of such conduct is facially apparent and condemnation of the practice is justified without inquiry into actual market conditions or possible competitive defenses.[25] In contrast, the Court applies the rule of reason standard when further inquiry into the market conditions is required to determine whether the particular business practice promotes or suppresses competition because such effects are not facially apparent.[26]

Because application of the *per se* rule automatically results in a finding of illegality, the initial characterization decision of which standard to apply is critical and perhaps outcome determinative.[27] The rule of reason standard requires further inquiry into the purpose and effect of challenged conduct, and thereby opens the door to justifications for such conduct. Obviously, avoiding imposition of *per se* liability, and thereby securing the ability to defend against claims of anticompetitive conduct, is of monumental importance to defending companies.

A. Tying Arrangements and the *Per Se* Rule

A tying arrangement or a "tie-in" occurs when the sale of one

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24. National Society of Professional Engineers v. United States, 435 U.S. 679, 692 (1978).

25. *See, e.g.*, Arizona v. Maricopa County Medical Society, 457 U.S. 332 (1982) (holding a maximum fee schedule agreed upon by doctors for insurance reimbursement as *per se* illegal price fixing, despite the possible benefits of health care cost containment).

26. *See, e.g.*, National Society of Professional Engineers v. United States, 435 U.S. 679, 692 (1978) (conducting a balancing test to determine the "competitive significance" of a canon of ethics prohibition on competitive bidding).

27. SULLIVAN & HARRISON, *supra* note 19, at 82.

good or service is conditioned upon the purchase of a second good or service.[28] Such arrangements are illegal under § 1 of the Sherman Act, which prohibits "[e]very contract in restraint of trade or commerce among the several States "[29] Historically, the Supreme Court has classified tying arrangements as *per se* illegal.[30] More recently, however, the Court has retreated from an outright *per se* rule, and now seems to apply a modified *per se* rule.[31] The changing levels of judicial standards are largely the result of divergent ecomomic theories regarding the competitive effects of tying arrangements.

To illustrate, the justification for placing tying arrangements in the *per se* illegal category stems from leverage theory.[32] Leverage theory asserts that firms with monopoly power in one product market can use restrictive practices, such as tying arrangements, to expand their power into a second market.[33] For example, prior to 1956, Kodak sold film on the condition that the buyer have the film processed by Kodak.[34] Since Kodak had a 90 percent share of the film market, the film processing condition foreclosed independent film processors from most of the film processing market. Thus, Kodak was able to "leverage" its monopoly power in the film market into monopoly power in the film processing market by tying the sale of film processing services to the sale of film.[35]

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28. Eastman Kodak Co. v. Image Technical Services, Inc., 112 S. Ct. 2072, 2076 (1992).

29. 15 U.S.C. § 1 (1982). Tying arrangements are also prohibited by § 3 of the Clayton Act, however, the application of that Act is limited to the sale or lease of commodities. 15 U.S.C. § 14 (1982). Thus, tying arrangements of goods and services are analyzed under the Sherman Act. SULLIVAN & HARRISON, *supra* note 19, at 185. However, the analysis of tying arrangements under the Clayton and Sherman Acts is essentially the same. *Id.*

30. *See, e.g.*, Jefferson Parish Hospital District No. 2 v. Hyde, 466 U.S. 2, 9 (1984) (stating that "It is far too late in the history of our antitrust jurisprudence to question the proposition that certain tying arrangements pose an unacceptable risk of stifling competition and therefore are unreasonable '*per se*'"); International Salt Co. v. United States, 332 U.S. 392, 396 (1947) (stating that it was "unreasonable, *per se*, to foreclose competitors from any substantial market").

31. *See infra* text accompanying notes 43-50.

32. The leverage theory was espoused by Harvard economist Donald Turner in contradiction to the work of "Chicago School" mentor Aaron Director. *See* Donald F. Turner, *The Validity of Tying Arrangements Under the Antitrust Laws*, 72 HARV. L. REV. 50, 60-62 (1958).

33. Louis Kaplow, *Extension of Monopoly Power Through Leverage*, 85 COLUM. L. REV. 515, 515-17 (1985).

34. DON E. WALDMAN, THE ECONOMICS OF ANTITRUST, 236 (1986).

35. As a result of this tie-in, Kodak held an unchallengeable share of the film pro-

From the leverage theory perspective, tying arrangements are used solely as an attempt to spread monopoly power from one market to another. Therefore, tie-ins represent the category of business practices that are plainly anticompetitive, and thus justifiably *per se* illegal. However, many commentators, particularly those in the "Chicago School," argue that the leverage theory is impossible as a matter of economic theory.[36] They assert that rational consumers will consider the totality of the tie-in package.[37] Thus, if an undesirable product is tied to the primary product, consumers will discount the utility of the primary product, demand less, and therefore reduce the seller's overall profits. No rational seller would use tie-ins to unlawfully monopolize another market because they will realize the impossibility of such a leveraging.

As a result, if a seller engages in tying, it must be for some other competitive purpose. Therefore, according to the "Chicago School" tie-ins do not represent those categories of practices that are justifiably *per se* illegal since it is not facially apparent that they implicate an anticompetitive purpose.

These differences between the leverage theory and the "Chicago School" underlie the evolution of the Court's analysis of tying arrangements. Adhering to leverage theory, the Court held tying arrangements to be *per se* illegal in *International Salt Co. v. United States*.[38] In that case, International Salt leased patented machines only on the condition that the lessees also purchase salt used in the machine from International Salt.[39] The Court stated that this tying arrangement was "unreasonable, *per se*," because it foreclosed competition in the salt market.[40] Decades later, however, in *Jefferson Parish Hospital v. Hyde*,[41] the Court seemed to move from strict adherence to leverage theory by upholding, only nominally, the *per se* status of tying.

In *Jefferson Parish*, a hospital contracted with a group of anesthesiologists to provide all of the hospital's anesthesiological needs. Thus, all patients having an operation at the hospital would be

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cessing market until 1956, when it entered into a consent decree ending the film/processing tie-in. *Id.* at 236-37.

36. Kaplow, *supra* note 33, at 515.

37. Richard A. Posner, *The Chicago School of Antitrust Analysis*, 127 U. PA. L. REV. 925, 929 (1979).

38. 332 U.S. 392 (1947).

39. *Id.* at 393.

40. *Id.* at 396.

41. 466 U.S. 2 (1984).

required to use one of the contracted anesthesiologists. The Supreme Court unanimously held that this arrangement did not violate the Sherman Act.[42] However, there was a five-to-four split as to why such an arrangement was legal.

Justice Stevens, writing for the majority, upheld the *per se* status of tying arrangements. However, the standard articulated was actually a modified version of a *true per se* standard. This modified version requires that threshold steps be met before a particular tie-in will be declared *per se* illegal. The plaintiff must prove (1) the existence of two separate products; (2) that the sale of one product is conditioned on the sale of the second product; (3) that the seller has significant market power in the tying product market enabling it to force consumers to purchase products they would not otherwise not buy; and (4) that a substantial amount of commerce is affected by the tying arrangement.[43]

The most important threshold requirement, for the purposes of this Comment, is that the seller must possess "significant market power" in the tying product market, and use this market power to force consumers to buy something they would otherwise not purchase.[44] This market power requirement derives from the leverage theory fear that monopolists will use tie-ins to spread monopoly power in one market into monopoly power in other markets. Thus, in the absence of a seller with significant market power, the concerns of the leverage theory are nonexistent because the seller does not have monopoly power to spread.

For example, in *Jefferson Parish*, the Court ruled that a hospital with a 30 percent market share did not possess enough power in the tying product market to force patients to use an unwanted anesthesiologist.[45] Furthermore, the Court held that imperfections in the health care market did not change the analysis. Market imperfections such as the patients' inability to evaluate the quality of care rendered by competing hospitals and their lack of price consciousness did not warrant a finding that the hospital had market power sufficient to force patients to use unwanted anesthesiologist services. Therefore, the Court declined to declare the hospital services/anesthesiological services tie to be *per se* illegal because the hospital's market share, even when combined with the market

42. *Id.* at 32.
43. *Id.* at 37-42.
44. *Id.* at 7.
45. *Id.* at 7, 28-29.

imperfections, did not "generate the kind of market power that justifies condemnation of tying."[46]

The concurring justices in *Jefferson Parish* agreed that the hospital services/anesthesiological services combination was not unlawful. However, Justice O'Conner, joined by Justices Burger, Powell and Rehnquist, urged the Court to abandon the *per se* label for tying arrangements.[47] They argued that the Court's partial *per se* approach, requiring the establishment of threshold steps in order to invoke the true *per se* rule incurs the same costs as the rule of reason approach without reaping the benefits. The threshold steps necessarily require that the Court engage in an "elaborate inquiry into the economic effects of the tying arrangement."[48] Thus, the dissent asserted that the Court should expressly adopt a rule of reason approach and thereby focus its analysis on adverse economic consequences and potential competitive benefits.

Jefferson Parish, by its articulation of a modified per se rule, serves as evidence of the Court's "increasing appreciation of economic analysis."[49] However, it also displays that a majority of the Court refuses to abandon the nomenclature of a *per se* rule, even if the resulting partial *per se* rule is in reality a label attached to what is essentially a rule of reason standard.[50]

B. Business Justifications to Tying Arrangements

Although tying arrangements retain at least a nominal *per se* illegal status after *Jefferson Parish*, they are unlikely to be held unlawful without consideration of the business justifications for the tie.[51] For example, tying arrangements may be deemed legal because the tie is used to facilitate the introduction of new products, or the promotion of goodwill.[52] Additionally, the tie-in may escape *per se* illegality because it enables economies of scale to be

46. *Id.* at 27.
47. *Id.* at 35.
48. *Id.* at 34.
49. Gellhorn, *supra* note 1, at 327.
50. *Id.*
51. Gary Myers, *Tying Arrangements and the Computer Industry:* Digidyne Corp. v. Data General Corp., 1985 DUKE L.J. 1027, 1047-48.
52. The goodwill defense is based on the fear that a manufacturer's product may not function properly when used with another firm's components. Thus, in an effort to maintain a reputation for quality and avoid consumer dissatisfaction, manufacturers must sell complementary products by use of a tie-in. *Id.* at 1049-50. *See also* Continental T.V., Inc. v. GTE Sylvania Inc., 433 U.S. 36, 55 (noting that vertical restraints may be used to maintain goodwill).

captured.[53] Furthermore, tie-ins may be justified as a means of eliminating the free-rider problem.[54]

The most notable case accepting business justifications as a defense to a tie-in claim is *United States v. Jerrold Electronics Corp.*[55] In that case, the seller of antenna systems required purchasers to buy its complete antenna system, despite the availability of separate components from other sellers. Additionally, the seller tied installation and maintenance to sale of the antenna equipment. The *Jerrold* court held that these tie-ins were appropriate during the start-up phase of the business and that the function of the tie was to assure the proper functioning of the system and the preservation of good-will.[56]

These defenses to otherwise *per se* illegal tie-ins reflect further acceptance of the "Chicago School" theory in antitrust analysis. These defenses indicate that courts may be willing to concede that there are economic justifications for tying arrangements instead of simply relying on leverage theory to hold such arrangements *per se* illegal.

C. *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*

In *Matsushita Electric Industrial Co. v. Zenith Radio Corp.*,[57] the Court went even further in its acceptance of "Chicago School"

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53. The joint production and sale of goods can result in lower cost of goods sold through the realization of economies of scale. *See* Myers, *supra* note 51, at 1053. *See also Continental T.V.*, 433 U.S. at 56 (noting that consumer savings may occur because of marketing efficiencies).

54. The free-rider defense addresses the problem of innovative companies being unable to fully recoup their investments in research and development when competitors piggyback on the research and development ("R&D") done by the innovator. This problem has been experienced in the computer industry. Large firms develop innovative hardware and software and bring them to market, while competitors await the market response. If the products are a success, the competitors will develop compatibles, utilizing the R&D done by the innovator. If the products are a flop, the competitors will turn to alternative ideas, leaving the innovator to bear the sunk cost of the product development R&D. *See* Myers, *supra* note 51, at n.181.

For example, in Digidyne Corp. v. Data General Corp., 734 F.2d 1336, 1343 (9th Cir. 1984), *cert. denied*, 105 S. Ct. 3534 (1985), Data General claimed that it needed to sell its hardware and software as a package in order to recover its R&D expenditures. *See also* Berkey Photo, Inc. v. Eastman Kodak Co., 603 F.2d 263, 281 (2nd Cir. 1979) (stating that "If a firm that has engaged in the risks and expenses of research and development were required in all circumstances to share with its rivals the benefits of those endeavors, [the creative] incentives would very likely be vitiated.").

55. 187 F. Supp. 545 (E.D. Pa. 1960), *aff'd per curiam*, 365 U.S. 567 (1961).

56. *Id.* at 557-58.

57. 475 U.S. 574 (1986).

theory In that case, a group of American television manufacturers alleged that a group of Japanese consumer electronics manufacturers had engaged in predatory pricing and illegal boycotting as part of a conspiracy to drive the American firms out of the consumer electronics market.[58] In ruling on whether the Japanese manufacturer's motion for summary judgment was properly denied by the Third Circuit, the Court first noted that the American firms' claim of a conspiracy made no economic sense. The Court accepted the economic theory that schemes such as the one alleged are rarely engaged in because they are rarely successful.[59]

Because the alleged conduct was not a rational practice according to economic theory, the Court held that to survive the motion for summary judgment, the American firms were required to "come forward with more persuasive evidence to support their claim than would otherwise be necessary."[60] In essence, *Matsushita* requires that plaintiffs challenging conduct deemed to be irrational under economic theory must present extra evidence to demonstrate why the economic theory is inaccurate in their particular circumstances or else face dismissal for failure to state a claim. As a result of this burden on plaintiffs, it seems the Court is adopting economic theory to establish presumptions of legal conduct. Thus, *Matsushita* signals the Court's increased willingness to rely heavily on economic theory to establish substantive antitrust law.[61]

III. *EASTMAN KODAK CO. V IMAGE TECHNICAL SERVICES, INC.*

Since the early 1980's, 18 independent service organizations ("ISOs") had been engaged in the business of providing service and replacement parts for Kodak photocopying equipment.[62] These ISO's would purchase the replacement parts from Kodak,[63] and

58. *Id.* at 577-78.

59. *Id.* at 589.

60. *Id.* at 587.

61. Matsushita may also have procedural importance. The case may stand for the proposition that courts should quickly dispose of antitrust claims that make "'no economic sense,'" by limiting the amount of discovery for these types of economically baseless claims. Michael L. Weiner & James A. Keyte, *Image Technical Services: More Than Meets The Eye*, ANTITRUST, Fall/Winter 1991, at 23.

62. Eastman Kodak Co. v. Image Technical Services, Inc., 112 S. Ct. 2072, 2076 (1992).

63. Kodak manufactured some of the replacement parts itself, and the rest were produced made to order for Kodak by independent original-equipment manufacturers. *Id.* at 2077. Thus, there really were two sources of the Kodak equipment replacement parts. However, since Kodak had the ability to control the independent manufacturers' distribu-

then independently offer their repair services to Kodak photocopier equipment purchasers.[64] Kodak, in addition to manufacturing and selling Kodak photocopying equipment, also separately sold annual service contracts and replacement parts for its equipment.[65] Thus, customers who purchased a Kodak photocopier had the choice of having the machine serviced and repaired by Kodak or one of the ISOs.[66]

In 1985, however, Kodak instituted a policy of selling photocopier equipment replacement parts only to those customers who used Kodak service.[67] By implementing this policy, Kodak intended to make it difficult, if not impossible, for the ISO's to sell service contracts for Kodak equipment by cutting off their supply to Kodak replacement parts.[68] The policy worked. The ISO's, unable to obtain the replacement parts, were unable to offer service for Kodak equipment. Some ISO's lost substantial revenue, while others were forced out of business.[69] Moreover, because of this policy, purchasers of Kodak photocopier equipment were required to use Kodak service even though they may have preferred to use the ISO service.[70]

As a result, the ISO's filed an action in the United States District Court for the Northern District of California, alleging that the Kodak policy was an unlawful tying arrangement.[71] After a period of limited discovery, the District Court found that there was no evidence to support the claim that Kodak tied the sale of its replacement parts and service to the sale of its photocopier equipment. The Court thus granted Kodak's motion for summary judgment.[72]

The Court of Appeals for the Ninth Circuit reversed, refusing to uphold the grant of summary judgment.[73] In contrast to the

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tion of the replacement parts, this Comment, for simplicity, discusses the facts in terms of Kodak as the only source of replacement parts.

64. *Id.*

65. *Id.*

66. *Id.* The customers could of course also choose to repair and service the photocopiers themselves.

67. *Id.* Kodak would also sell parts to customers who chose to repair their own machines.

68. *Id.* at 2078.

69. *Id.*

70. *Id.*

71. *Id.* at 2076, 2078.

72. *Id.* at 2078.

73. *Id.*

District Court, the Ninth Circuit found that a tying arrangement existed by holding that Kodak had essentially conditioned the sale of its replacement parts on the purchaser's agreement NOT TO BUY services from an ISO.[74] The Ninth Circuit, adhering to the *Jefferson Parish* test, then considered whether Kodak had "sufficient economic power in the tying product market [parts] to restrain competition appreciably in the tied product market [service]."[75]

Kodak used "Chicago School" theory as proof that it lacked market power in the tying product market, the replacement parts market. Kodak asserted that competition in the photocopier equipment market necessarily precluded a finding of market power in the derivative parts market.[76] The Ninth Circuit agreed with Kodak that the economic reality of competition in the photocopier equipment market might serve to prevent Kodak from possessing the required market power in the parts market. However, the Ninth Circuit refused to uphold the grant of summary judgment"' on this theoretical basis' because 'market imperfections can keep economic theories about how consumers will act from mirroring reality '" [77]In other words, the Ninth Circuit was unwilling to rely on economic theory alone to set the standard necessary to survive a motion for summary judgment.

The United States Supreme Court subsequently granted certiorari to address the issue of whether the Ninth Circuit's refusal to rely on economic theory under these circumstances was proper.[78]

A. The Majority Opinion

Justice Blackmun in an opinion joined by Chief Justice Rehnquist and Justices White, Stevens, Kennedy and Souter, affirmed the Ninth Circuit opinion that reliance on economic theory to form a legal presumption of insufficient market power was improper in this case. Blackmun held that the use of Kodak's economic theory to set forth a legal presumption was inappropriate because the theory did not reflect the photocopier market realities. Specifically, Blackmun challenged Kodak's asserted connection be-

74. Image Technical Service, Inc. v. Eastman Kodak Co., 903 F.2d 612, 615 (1990), *aff'd*, 112 S. Ct. 2072 (1992).

75. *Id.*

76. *See supra* text accompanying notes 9-12.

77. *Kodak*, 112 S. Ct. at 2078-79.

78. *Id.* at 2076.

tween service and parts prices and photocopier equipment sales.[79] Kodak had asserted that in making purchasing decisions, customers would evaluate the different photocopier brands based on the cost of the total package: equipment, parts and service costs.[80] Thus, Kodak claimed that if it charged non-competitive prices in the parts and service markets, customers would regard this as increasing the cost of the total Kodak photocopier equipment package, and would switch to an equipment brand with a lower total price. Blackmun, however, rejected Kodak's theory, finding it an inaccurate description of the photocopier market.

First, Blackmun explained that consumers would not be able to evaluate the total photocopier package cost due to information costs.[81] Blackmun noted that the accurate prediction of the total cost of such complex equipment would entail the accumulation of sophisticated information including the "price, quality and availability of products needed to operate, upgrade, or enhance the initial equipment, as well as service and repair costs, including estimates of breakdown frequency, nature of repairs, price of service and parts, length of 'down-time' and losses incurred from down-time."[82] Blackmun suggested that this type of information is either very costly or impossible to ascertain at the time of purchase. As a result, he stated that many consumers would be incapable of making total package price computations, or alternatively would simply choose not to make such calculations.

As an example, Blackmun noted that the federal government's purchasing systems render the government unable to ascertain the total package cost at the time of purchase.[83] Thus, Blackmun concluded that it is unlikely that consumers make photocopier purchasing decisions only after a consideration of the total cost of the equipment, parts and service during the life of the machine.[84]

Additionally, Blackmun determined that costs associated with switching products prevented Kodak's theory from accurately describing the photocopier market.[85] Blackmun accepted the ISO's argument that because of the high initial cash outlay for the photo-

79. *Id.* at 2082-89.
80. *Id.* at 2085.
81. *Id.* at 2085-87.
82. *Id.* at 2085.
83. *Id.* at 2086.
84. *Id.* at 2087.
85. *Id.*

copier equipment, consumers are unlikely to switch to an alternative brand when parts and service costs increase.[86] In other words, because of the sunk cost of the initial cash outlay, consumers become locked-in to their original brand.

As a result of the existence of these possible market imperfections in the form of information and switching costs, the majority held that Kodak was not entitled to an economic theory based legal presumption of lack of market power in the derivative parts market.[87] In short, the majority found that the possibility of market imperfections created a material issue of fact as to whether Kodak's theory was an accurate description of reality Thus, according to the majority the use of economic theory to grant summary judgment was inappropriate in this case. Instead, Kodak is required to withstand trial, and prove that its economic theory is indeed representative of reality in order to successfully defend its replacement parts policy

B. The Dissenting Opinion

Justice Scalia, joined by Justices O'Conner and Thomas, disagreed with the analysis of the majority opinion.[88] Scalia accepted the assumptions on which Kodak's economic theory was based, and as a result, felt that Kodak was entitled to summary judgment premised on economic theory alone.[89] Moreover, he argued that the bundling of derivative goods and services by manufacturers engaged in a competitive primary equipment market is not the type of business practice that implicates the dangers that justify *per se* illegality [90]

In accepting Kodak's economic theory as adequate proof of its lack of required market power, Scalia addressed the issue of possible market imperfections raised by Blackmun. First, Scalia accepted Kodak's argument that rational consumers would consider the total package cost of the photocopier before making a purchasing decision.[91] Thus, if Kodak implemented its new policy in an effort to charge excessive prices for its replacement parts and service, customers would switch to a brand with lower total costs. Scalia

86. *Id.*
87. *Id.* at 2087-89.
88. *Id.* at 2092.
89. *Id.* at 2101.
90. *Id.* at 2092-94.
91. *Id.* at 2097.

agreed with Blackmun's point that some customers may be precluded from factoring the total package costs into their purchasing decisions.[92] But, Scalia reasoned that this type of customer represents the "lowest common denominator of consumer," and not the average rational consumer.[93] Furthermore, Scalia maintained that even if the federal government, as the majority opinion pointed out, is unable to consider the total package cost of photocopiers, most rational consumers could, and would.[94]

Additionally, Scalia discounted Blackmum's assertion that consumers cannot switch to an alternative photocopier brand because they become locked-in to the original brand due to the heavy initial cash outlay Scalia termed this lock-in phenomenon "circumstantial leverage," which occurs frequently, even in perfectly competitive markets, and is of no concern to antitrust law For example, Scalia noted that the leverage Kodak has due to this lock-in phenomenon is no different from the leverage possessed by the manufacturer of a malfunctioning refrigerator, which results from the customer's reluctance to abandon his initial investment, or the leverage obtained by an airline manufacturer over an airline that has standardized its fleet around that manufacturer's models. Thus, according to Scalia's logic, the lock-in phenomenon would create leverage for any manufacturer that produces unique and expensive products. Quoting Judge Posner, Scalia recognized that although this type of market power may result in injury to certain consumers, "it produces only 'a brief perturbation in competitive conditions — not the sort of thing the antitrust laws do or should worry about.'"[95]

After disputing the significance of Blackmun's perceived market imperfections, Scalia went on to consider Kodak's parts policy in terms of its potential impact on competition. Citing *Jerold Electronics* for the proposition that courts often recognize that some restraints or tie-ins serve competitive purposes, Scalia suggested that the Kodak replacement parts policy may advance such legitimate goals.

By proposing an inquiry into the effects on competition, Scalia reiterated the plea to abandon the *per se* status of tie-ins made by Justice O'Conner in *Jefferson Parish.* Scalia asserted that the rule

92. *Id.*
93. *Id.*
94. *Id.*
95. *Id.* at 2098.

of reason approach is the superior standard of evaluation for tie-ins since that standard would allow the study of any actual anticompetitive effect as well as potential competitive benefits. However, since the ISO's had waived any rule of reason claim in the District Court, Scalia declined to evaluate whether Kodak's parts policy actually advanced legitimate competitive purposes. Thus, Scalia was left to determine whether Kodak's decision to sell its replacement parts only to those purchasing its service constituted a *per se* illegal tie-in.[96]

Because Scalia accepted Kodak's economic theory as an accurate description of reality, he found it impossible that Kodak had the market power required to put its tying arrangement into the *per se* illegal category.[97] Since he declined to find Kodak's policy *per se* illegal, and since the ISO's had waived a rule of reason claim, Justice Scalia felt Kodak was entitled to summary judgment.[98]

IV ANALYSIS

A. A Setback for the Chicago School

The *Kodak* case is significant because it indicates that the Supreme Court is reversing its trend of relying on economic theory to develop substantive antitrust law In future antitrust cases, it now appears that parties will be forced to factually demónstrate the effect on competition caused by the challenged conduct. Reliance on economic theory alone will not suffice. Thus, the Court's retreat from economics in *Kodak* is clearly a setback for "Chicago School" adherents who seek to fully integrate their economic theory into antitrust law

Given the background of the Court's increasing acceptance of "Chicago School" principles, it is surprising that the Court suddenly rejected economic theory in *Kodak*.[99] As discussed, the Court, beginning with *Jefferson Parish*, began to adopt "Chicago School" principles into its analysis of tying arrangements. In that case, the Court, by requiring threshold steps to be met before holding a tie-in to be per se illegal, rejected an outright acceptance of the leverage theory Moreover, the threshold steps of the modified *per se* rule indicated that the Court was willing to partially accept the

96. *Id.* at 2101.
97. *Id.*
98. *Id.*
99. *See supra* notes 41-61 and accompanying text.

"Chicago School" argument that sellers could not use tie-ins to leverage power from one market to another. The Court found "Chicago School" principles to apply when the threshold steps could not be established. This trend of accepting "Chicago School" principles in the analysis of tying arrangements accelerated further when courts began to recognize defenses to otherwise *per se* illegal tie-ins based on economic justifications. Finally, the Supreme Court apparently fully embraced "Chicago School" principles in *Matsushita* by requiring plaintiffs to come forward with "more persuasive evidence" than would otherwise be necessary when their claim does not make sense according to economic theory In *Kodak*, however, the Court retracted the *Matsushita* holding by declining to read that decision as a mandate for summary judgment when the plaintiff's claim does not conform to economic theory This reading of *Matsushita* is difficult to understand since the Court expressly stated in that case that "if the [plaintiff's] claim is one that simply makes no economic sense — [the plaintiff] must come forward with more persuasive evidence to support their claim than would otherwise be necessary" to survive a motion for summary judgment.[100] The reasonable interpretation of this language is that *Matsushita* imposed a greater burden on plaintiffs in antitrust cases than in other types of cases for purposes of summary judgment.[101]

Based on this trend and the language in *Matsushita*, then, one would have thought that the Court would have granted Kodak's motion for summary judgment because the ISO's claim contradicted Kodak's economic theory that the replacement parts policy could not be used for anti-competitive purposes, and the ISO's failed to introduce persuasive evidence that proved this economic theory invalid. The ISOs only introduced other theories about potential market imperfections, not actual evidence that disproved Kodak's theory

Instead of following this path, however, the Court claimed that *Matsushita* did not impose a greater burden on plaintiffs in antitrust cases, and specifically refused to accept Kodak's economic theory to form a legal presumption. By refusing to uphold Kodak's

100. Matsushita Electric Industrial Co., Ltd. v. Zenith Radio Corp., 475 U.S. 574, 587 (1986).

101. In fact many lower courts accepted this interpretation. Ronald S. Katz & Janet S. Arnold, *Eastman Kodak v. ITS*: The Downfall of the Chicago School, THE COMPUTER LAWYER, July, 1992, at 1.

motion for summary judgment, the Court has moved antitrust law to a fact-based analysis from economic theory based standards, since Kodak now must factually demonstrate the validity of its theory at trial. Practically speaking, this means that antitrust defendants will be subjected to more trials, as summary judgment will no longer be granted simply because economic theory supports such a dismissal. Instead, antitrust defendants will be required to litigate the validity of their economic theory

B. Result on Competition

The Court's newly found reluctance to rely on economic theory in *Kodak* raises questions about the effect on competition, if any, that will result from this doctrinal shift. The advancement of competition, after all, is the main goal of antitrust policy [102] While the decision's effect on competition overall is difficult to ascertain at this point, speculation regarding the effect *Kodak* will have on the photocopier market is instructive.

Some commentators view *Kodak's* rejection of rigid adherence to "Chicago School" theory as an advancement of competition.[103] For example, Ronald Katz and Janet Arnold maintain that *Kodak* will enable the ISO's to compete with Kodak in the photocopier repair service market, and therefore create greater choice and lower prices for consumers.[104] Moreover, these commentators suggest that *Kodak* will force manufacturers such as Kodak to avoid the development of policies that foreclose competition in aftermarkets.[105]

Other commentators, however, view *Kodak* as a sign of "a return to the pre-economic dark ages of antitrust."[106] For example, Professor Glynn Lunney suggests that photocopier consumers may not benefit from *Kodak.*[107] Lunney notes that consumers are unlikely to see lower repair costs because Kodak controls the supply of replacement parts for Kodak photocopiers, and so the ISO's charge for repairs in part depends on the price which Kodak charges for the replacement parts.[108] Thus, even if the ISO's are able

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102. *See supra* text accompanying notes 19-21.
103. *See, e.g.*, Katz & Arnold, *supra* note 101.
104. *Id.*
105. *Id.*
106. Frum, *supra* note 5, at 72.
107. Glynn S. Lunney, Jr., *Another View of* Eastman Kodak v. ITS, THE COMPUTER LAWYER, November 1992, at 22.
108. *Id.*

to charge lower prices for the labor aspect of the repair service, Kodak will simply raise the price it charges for replacement parts. Lunney demonstrates this effect in an example:

> assume that the typical repair costs $100, which Kodak presently breaks down into a $50 charge for parts and a $50 charge for labor. An ISO might charge only $25 for the labor involved in the typical repair, which suggests that approximately $25 of Kodak's labor charge (arguably) represents a monopolistic mark-up. If the ISO's could obtain the necessary parts at the same $50 Kodak presently charges its customers, then consumers would have to pay only $75 for the repair, and would come out $25 dollars ahead by using the ISO Kodak, however, can obtain the same $25 profit for the typical repair by increasing the price of its parts to $75 and reducing the price of its labor to [$25].[109]

In this situation, consumers would pay $100 for service regardless of whether they hired Kodak or one of the ISO's. With either choice, they would pay $75 for parts and $25 for service.

This pricing scheme results only because the ISO's are dependent on Kodak for their supply of Kodak replacement parts. Thus, the ISO's could only offer repair service for less than $100 if they develop substitutes or clones of Kodak replacement parts for less than Kodak's price of $75. As a result, the belief that ISO's will be able to offer lower total repair prices is dependent on the assumption that they will succeed in developing substitutes for Kodak brand replacement parts.

Lunney notes, however, that the ISO's potential for development of adequate substitutes for Kodak brand replacement parts is uncertain since such substitutes were not at all developed during the seven year existence of the ISOs.[110]

Thus, the competitive effects of *Kodak* in the photocopier market are uncertain. The ISO's may be able to offer consumers lower repair costs if they are able to develop substitutes for Kodak brand replacement parts. Without adequate substitute replacement parts, however, it is probable that the ISO's will not be able to offer lower total repair costs than Kodak because Kodak controls the

109. *Id.*
110. *Id.*

supply and costs of the parts. Thus, photocopier consumers will benefit only if the ISO's make efforts to compete with Kodak in the supply of Kodak-compatible replacement parts. Specifically, consumers will benefit only if the ISO's develop a more efficient source of Kodak-compatible replacement parts.

This probable result, that competition will not be increased in the photocopier repair market, caused one commentator in *Forbes Magazine* to ask, "Are we slipping back to the bad old days so far as antitrust is concerned, back to the days when the courts put inefficient businessmen ahead of consumers?"[111] In other words, is *Kodak's* protection of the ISO's unjustifiable since the consumer benefits resulting from their existence are unlikely, or at best, uncertain?

The Court's willingness to protect the ISO's in *Kodak* may stem from a populist oriented goal of preserving individual entrepreneurial opportunity.[112] The problem of protecting individual entrepreneurs, however, is that this goal results in a "policy of protecting competitors rather than competition."[113] Thus, the result of *Kodak* may be the advancement of populist social or political goals, at the expense of market competition, and in violation of the basic assumptions of antitrust law [114]

V CONCLUSION

Antitrust law, prior to *Kodak*, was developing into a body of law based on economic theory *Matsushita* suggested that the Court had reached the point of complete acceptance of "Chicago School" theory by indicating that parties could defend against antitrust allegations merely by asserting that the allegation is contrary to economic theory In *Kodak*, however, the Court retreats from its embracement of economic theory Now, defendants must introduce evidence to prove that its economic theory does in fact reflect

111. Frum, *supra* note 5, at 72.

112. Kurt A. Strasser, *An Antitrust Policy For Tying Arrangements*, 34 EMORY L.J. 253, 283 (1985).

113. *Id.* at 284.

114. *See supra* notes 19-21, and accompanying text (noting that antitrust law is based on the assumption that society is better off when markets are competitive).

If nothing else, *Kodak* certainly is in contradiction to the Reagan Administration's success in redirecting federal antitrust enforcement policy towards free market competition goals. *See generally* William E. Kovacic, *Reagan's Judicial Appointees and Antitrust in the 1990's*, 60 FORDHAM L. REV. 49 (1991) (discussing Reagan's efforts to redirect antitrust policy in the courts).

commercial realities. Alternatively, plaintiffs can now challenge certain conduct merely by attacking the assumptions on which the defendant's economic theory is based.

Kodak signals a new use of economic principles by the Court. After *Kodak*, economic theory is still relevant, but not dispositive. As a result of the Court's refusal to rely on economic principles alone, antitrust claims will become more factually based.[115] Practically, Kodak signals that fewer cases will be dismissed on summary judgment, since parties will have to factually prove their economic theories. Presumably, then, we can expect to see more antitrust claims proceeding to trial in the District Courts.

Kodak may, however, signal more than just an increased antitrust docket for the District Courts. The Court's refusal to decide antitrust claims based solely on economic theory may implicate more than just a setback for "Chicago School" adherents, who would readily decide such claims by reference to economic theory alone. Threads of populism may underly the Court's refusal to accept Kodak's economic theory on its face. If *Kodak* signals that populism is creeping into antitrust law, the decision may have adverse implications for competition. Antitrust policy based on populism, as opposed to economic theory, may result in the protection of individual competitors, but not overall competition. As a result, antitrust law may once again be subject to Justice Holmes' criticism of being "humbug based on economic ignorance and incompetence."[116]

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115. Evidence that the Court intends to move away from an economic theory based analysis is provided by Virtual Maintenance v. Prime Computer, Inc., 957 F.2d 1318 (6th Cir. 1992), *rev'd*, 113 S. Ct. 314 (1992), which involved facts similar to *Kodak*. The Supreme Court reversed and remanded the Sixth Circuit's opinion, decided prior to *Kodak*, which had relied on economic theory to dismiss a tying claim.

116. *See supra* note 1 and accompanying text.